RECOVERY STOCKS, HEALTH HAZARDS AND AIR WARS - AUSTRALIAN EQUITIES INSIGHTS

PERPETUAL INVESTMENTS
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Are we looking at a V, U or L?

Some stability in markets has given investors breathing room to try and look further ahead, to the shape and nature of the recovery in economic activity and markets. There are as many questions as answers emerging and despite a proliferation of new COVID experts (perhaps the fastest growing new industry), there are still many clouds on the horizon.

The bulls supporting a 'V' shaped recovery point to China, South Korea and Taiwan as examples of where infection rates peaked fairly quickly, and life can return to normal sooner than expected. Equity markets are always looking forward to try and price future profits and forget history quickly. The equity market would want nothing more than to embrace this bull case. Since the equity market tends to look forward about 3-12 months (hence why equities often turn down in the months ahead of a recession) then this scenario may have already played out.

However, there are several complexities that the bulls haven't considered. Infection rates in the world's biggest economy (and market) are yet to peak, which seems to have been an important pivot point for markets. The University of Washington has projected that over 80,000 people may die in the US, but the range of estimates is 41,000 through to 177,000 with deaths peaking on 16 April – still some time away. Much depends on state government responses to the pandemic. It's hard to see markets putting this crisis behind them until they can be sure that the worst scenario doesn't play out. Then there's the emerging world, where the coronavirus has barely begun spreading.

Lastly, what if it comes back? Comparisons have been made to the Spanish flu, but there has been less emphasis on the fact that the Spanish flu came in three waves: the spring of 1918, then the autumn of 1918 and finally the winter of 1919. Schools and other venues were closed, re-opened and closed again before daily life returned to normal. Australia has the added complexity of heading into winter.

For us it is way too early to be confident that new shocks will not present themselves in the months ahead, with no credible estimate of a vaccine sooner than a year from now. Even the worst economies always bounce back eventually, so talk of an 'L' shaped recovery is for extremists only, but the possibility of a long 'U' shaped recovery looms large, despite all the money thrown at the problem, particularly as Australia faces its first recession in 29 years. We will clearly need to account for the second round of further economic contagion and the psychological effect all this will have on the leveraged Australian consumer emerging from shutdown later this year.

For this reason we continue to comb through our portfolios to ensure the companies we own have the resources to “hibernate” and endure the tough times to come, as well as looking for new, reasonably priced companies that should thrive once recovery starts to emerge.

Below we address some of the things we are grappling with this week:

Recovery stocks

We continue to look at a number of companies that may be beneficiaries of outsized share price bounces once the present crisis passes. We have been struck by how the market has often made little or no distinction between high- and low-quality firms in some industries. It seems to be a case of shooting first and asking questions later. In many cases some of the stocks that have fallen hardest have a better chance of bouncing back quickly. However, it is important to ensure that the recovery stocks chosen:

1. Have the capital to get through the crisis
2. Ensure their business model and brand stay sufficiently intact to benefit from recovery
3. Are able to quickly restart their business as the recovery begins

Companies may find themselves with a plan but no ability to execute it. Or they find themselves in industries where the consumer recovery is lagged or where consumer behaviour has changed. Also, the competitive landscape will be critical. We need to keep an eye on key competitors in the recovery phase. In some sectors large percentages of the competition may be impaired (e.g. retail) and in some cases we think nearly all the competition will be troubled (e.g. Aristocrat’s competitors).

It makes sense that the hunting ground for recovery stocks will mostly be in the value-oriented, cyclical sectors that have taken most of the heat in this correction so far, including resources, building/construction and consumer discretionary.

Portfolios: We have already topped up our favourite existing holdings. More and more companies will come to market seeking equity and these may prove the ideal entry point as we continuously assess their prospects considering their changed position.

Industry case study: Air wars

There has been extensive discussion of the fate of Qantas and Virgin given that they are front and centre of COVID-19 ravage. Contrary to opinion in some quarters, Qantas does not want Virgin to fail. Qantas runs a profitable, full service domestic airline with a rusted on corporate customer base. Virgin plays to the discount market and the two exist in a happy duopoly. Qantas created Jetstar to help check Virgin in the discount market, but without pushing it over the edge. Qantas has three times the revenue of Virgin and a stronger balance sheet. The reason Qantas does not want Virgin to fail is that if it didn’t exist, another company would enter the market. A viable but weak Virgin with a minority lock on the market blocks other competitors from coming into this “natural duopoly”. There is a real chance that a newcomer could be a lot better capitalised, much lower cost and much more ruthless than Virgin, all of which would be damaging for Qantas. So far we have seen the amusing scenes of the airlines asking for a bailout. When the idea of nationalising Virgin was mooted, Qantas was quick to say that it didn’t favour that much of a bailout! In the end its preference would be for Virgin to be rescued by its owners or receive some government support to keep it alive (and only just alive) but also only if Qantas also received enough support to maintain the status quo. It can be a fickle industry to invest in, and there is a significant level of risk because of the large fixed cost of planes and volatile fuel prices, but of course everything has a price and money can be made. Qantas is a very cyclical stock and it has fallen much lower than its current share price previously. However, there are ways to invest in the same travel theme without the same risks and where prices have already fallen to very low levels: travel agencies.

Portfolios: We are open to investing in Qantas at the right price, and it’s in our quality universe, but the stock is still above where it needs to be for us. As are the risks, for now. However, Flight Centre, which has already suffered a steep drop, and is raising new equity, may offer similar exposure to travel through a well-managed brand. Flight Centre is currently in the process of restructuring its business for the future and will have financial resources to survive with zero revenue for around a year or more. Whilst the Qantas share price has halved since February, by contrast Flight Centre is down from over \$40 to \$9.91 before the trading halt and looking to raise equity at even lower levels this week. We think this is the best place to put capital to work first: in a good business already trading at a steep discount.

Banks and dividends?

Europe has already ordered banks to cut dividends and New Zealand followed suit. This immediately led to speculation that it could happen in Australia. It does put policymakers in a quandary. If policymakers order banks to cut dividends, then the retained profits would significantly boost the safety of bank balance sheets. But is this necessary? Not only may it be overkill but it also prevents banks from making optimal decisions about their own balance sheets. Some may choose to cut dividends, whilst other may chose dividend reinvestment schemes to boost capital. Already we are seeing banks convert hybrids into common equity. Furthermore, it may do more harm than good if it means individuals, including self-funded retirees, who have put a lot of their savings in bank shares suddenly find that they don't have the dividend income they were expecting to fund their spending needs. The markets have already priced in some cuts to dividends but would respond badly in the short term to a unilateral announcement. The US announced Friday it would not force the banks to cut dividends for now.

Portfolios: We have been underweight most of the big four banks for some time. We have chosen to have most of our active financials' exposure in Suncorp. Whilst many perceive Suncorp as a bank, it is primarily an insurance company with AAMI, APIA, GIO and Shannons amongst its stable of brands. A large business efficiency program has also been executed which has begun to deliver significant net benefits. This combination of banking and insurance with significant upside to the bottom line is, in our view, a more diversified way to invest in financials beyond the big four and the insurance companies, as well as fund a more sustainable dividend, although it has yet to deliver on its potential.

Health hazards

The health sector has held up remarkably well in this crisis, although a number of issues may emerge for investors. The glamour stocks such as CSL, Resmed and Cochlear trade on significant multiples and seem unaffected at this stage. However, Cochlear was quick to raise money. Although it had a seemingly strong balance, it also faces significant litigation costs from a recent case which are yet to be realised.

Additionally, elective surgery has been deferred for the foreseeable future. This leaves many of these healthcare names with significant revenue challenges. Some companies may be able to shift their businesses temporarily towards manufacturing ventilators or other coronavirus related products, but it remains to be seen if this will occur. In the meantime, some of their core businesses will suffer. We are surprised that their share prices have held up as strongly as they have at very expensive levels.

By contrast private hospitals have corrected sharply with recent pressure on private hospitals costs from healthcare insurers accentuated by the ban on elective surgery. Since then the Federal Health Minister has temporarily integrated the private and public hospital systems to help manage coronavirus. This may prove a good opportunity to enter some of these stocks which once traded at much higher multiples.

The clear winner in all of this however is Medibank. Medibank's investment in data several years ago gave it the information advantage to better manage its insurance claims and the ban on elective surgery will reduce insurance claims even further.

Portfolios: We have owned Medibank and it has held up very well. Whilst the sharp fall in hospital valuations may present as an opportunity, we remain amazed that some of the large healthcare names have hardly fallen from very high P/E multiples despite some evidence that their businesses may also be affected.

Who's going to pay for it all?

The enormous support provided by the government draws anything we have seen since World War II. Last week's "JobKeeper" package brought the governments total support to $320 billion, or 16.4% of GDP, although this includes $105 billion of measures that are non-fiscal, mostly financing facilities through the RBA. Since then, the government has also announced other measures for childcare and indicated more is to come. So, the fiscal support is not complete. On top of this, there will be the "automatic" effects of less tax revenue from workers losing their jobs and government spending ratcheting up beyond the discretionary spending already announced. We are looking at staggering deficits and unprecedented peacetime rises in public debt.

This all begs the question of who is going to pay for all this? Clearly tax rates will have to rise at some point, but who will bear the brunt? Temporary Medicare levies, a favourite of recent governments in times of crisis, won't be enough. Governments are loathed to hike income tax, although bracket creep has historically been a tool to achieve the same result. The GST may need to be looked at, which may also affect some sectors more. And corporate tax or franking credits may come under scrutiny. Given that franking credits were front and centre of the recent election the government may well shy away from that option. However, given the scale of government support for business a higher corporate tax rate is not to be ruled out. The government has allowed distressed investors to access some of their superannuation, although this seems to have created liquidity problems for some of the major super funds. A measure not talked about currently would be a temporary suspension in the payment of Superannuation Guarantee (SG) and paying it instead as ordinary income. Even if unemployment rose from 5% to 10% the suspension of SG would immediately and significantly boost the income of the 90% of so of those still employed. It would also boost government tax revenue as superannuation contributions are moved from the low tax superannuation regime to higher marginal tax rates, allowing the government to fund higher support for those who lose their jobs during this period.

But government won't be the only entity to pay. Ultimately, we will all pay more as consumers as costs are passed on. And the temporary rescue of companies and jobs buys time but may not necessarily save some businesses or jobs down the track. Some badly structured, poorly managed and unsustainable "zombie" businesses were probably already headed for the wall and the government and RBA will need to be careful about bailing out failed companies that drag down productivity and absorb valuable capital resources that could be more effectively employed elsewhere.

The last time a comparable event happened, the Spanish flu, economies were very different. A century on the global economy has become significantly more “financialised” with a vast array of financial instruments that have augmented our ability to grow GDP. However, these instruments have also enabled greater risk by allowing leverage to be applied at higher ratios and today large levels of corporate debt are the weak link in the global economy. Governments and central banks have bent over backwards to support these links. Once the immediacy of the current crisis passes it will be very difficult for governments to support continued expenditure of ordinary taxpayer funds for continued corporate bailouts. It is this end game that investors need to eventually focus on.

Investors will also need to take into account a growing reality that government debts around the world become so large that governments will be compelled to inflate away vast amounts of government debts through monetisation and financial repression, much like governments had to do after World War II and in the 1970s. Modern Monetary Theory, which seemed like a fringe idea recently, has suddenly become more realistic. In these scenarios’ companies with real assets like property and commodities become much more valuable.

Portfolios: We think investors have forgotten the importance of investments with hard asset backing. Event Hospitality and Entertainment is a good example. Yes, the cinemas and resorts are currently closed but the company has a $2.1 billion property portfolio. Yet the market capitalisation of the company is now around half that at $1.2 billion. Management have always been excellent and financially conservative. Clearly this is not just a steeply discounted opportunity but also gives portfolios protection against any potential for more extreme policy measures to play out.

FURTHER READING - COVID-19

Visit our COVID-19 Insights Hub for economic and market updates to keep you informed as the situation evolves.